

Part III - Administrative, Procedural, and Miscellaneous

Withholding on Wages of Nonresident Alien Employees Performing Services within the United States

Notice 2005-76

I. PURPOSE

This notice provides new rules for determining the amount of income tax employers must withhold under section 3402 of the Internal Revenue Code (Code) from wages paid for services performed by nonresident alien employees within the United States. This notice also provides new rules for use by nonresident alien employees in completing Form W-4, Employee's Withholding Allowance Certificate. The rules for employers and employees are effective with respect to wages paid on or after January 1, 2006.

Because certain nonresident alien employees were experiencing overwithholding of income tax on their wages for services performed within the United States, the Internal Revenue Service has reconsidered the requirements for determining the amount of income tax to be withheld under section 3402 from the wages of nonresident alien employees. These new rules are designed to provide for withholding on the wages of a nonresident alien employee that more closely approximates the income tax

liability of the nonresident alien.

II. BACKGROUND

A. Income Tax Withholding on Wages of Nonresident Alien Employees

Pursuant to the statutory provisions and regulations set forth below, employers are generally liable for the withholding of income tax on remuneration for services performed within the United States by a nonresident alien employee.

Section 3402(a)(1) of the Code provides that, except as otherwise provided in section 3402, every employer making a payment of wages shall deduct and withhold from such wages a tax determined in accordance with tables or computational procedures prescribed by the Secretary of the Treasury. Section 3402(a)(1) further provides that any tables or procedures prescribed under section 3402(a)(1) shall be in such form, and provide for such amounts to be deducted and withheld, as the Secretary determines to be appropriate to carry out the purposes of chapter 1 (imposition of individual income tax).

Section 3401(a) of the Code provides that generally the term “wages” includes all remuneration for services performed by an employee for his employer. Section 3401(a)(6) provides an exception from wages for remuneration paid for such services performed by a nonresident alien individual as may be designated by regulations prescribed by the Secretary.

Pursuant to the authority granted under section 3401(a)(6), section

31.3401(a)(6)-1(b) of the Employment Tax Regulations provides that remuneration paid to a nonresident alien individual for services performed outside the United States is excepted from wages and hence is not subject to withholding under section 3402. Section 31.3401(a)(6)-1(a) conversely provides that, unless otherwise excepted, remuneration paid for services performed by a nonresident alien individual as an employee constitutes wages if such remuneration is effectively connected with the conduct of a trade or business within the United States.

Section 864(b) of the Code defines the term “trade or business within the United States” to include the performance of personal services within the United States at any time during the taxable year. Section 864(b)(1) provides an exception to this definition for the performance of personal services (A) for a nonresident alien individual, foreign partnership or foreign corporation not engaged in a trade or business within the United States; or (B) for an office or place of business maintained in a foreign country or in a possession of the United States by an individual who is a citizen or resident of the United States or by a domestic partnership or corporation, by a nonresident alien individual temporarily present in the United States for a period or periods not exceeding a total of 90 days during the taxable year and whose compensation for such services does not exceed \$3,000 in the aggregate.

Assuming the nonresident alien individual engages in a United States trade or business under section 864(b) because he performs personal services in the United States during the tax year, section 1.864-4(c)(6)(ii) of the Income Tax Regulations provides that wages, salaries, compensations, or other remunerations received by the

nonresident alien individual for performing those personal services in the United States constitute income that is effectively connected for the taxable year with the conduct of the trade or business in the United States by that individual.

Thus, employers, regardless of whether they are U.S. persons, are generally liable for the withholding of income tax on remuneration for services paid to nonresident alien employees to the extent the remuneration is attributable to services performed in the United States.

Section 3402(f)(2)(A) of the Code provides that every employee who receives wages shall provide his or her employer with a signed withholding exemption certificate relating to the number of withholding exemptions which the employee claims, which number shall in no event exceed the number to which he or she is entitled.

Section 3402(f)(5) of the Code provides that withholding exemption certificates shall be in such form and contain such information as the Secretary may by regulations prescribe. Section 31.3402(f)(5)-1(a) of the Employment Tax Regulations prescribes the form of the certificate as the Form W-4.

Although section 3402(f)(1) of the Code provides that an employee receiving wages shall on any day be entitled to certain listed withholding exemptions, nonresident alien employees are generally entitled to claim only one withholding exemption on Form W-4. Section 3402(f)(1)(A) provides an exemption for the employee unless the employee is an individual described in section 151(d)(2), regarding certain dependents.

Section 3402(f)(6) provides that notwithstanding the provisions of section 3402(f)(1), a nonresident alien individual (with certain exceptions) shall be entitled to only one

withholding exemption.

Section 3402(l)(3)(A)(ii) provides that for purposes of determining whether to claim married status when furnishing a withholding exemption certificate, an otherwise married employee shall on any day be considered as not married if either he or his spouse is, or on any preceding day within the calendar year was, a nonresident alien. See also section 31.3402(l)-1(c)(1) of the regulations to the same effect.

Section 63(c)(6)(B) provides that in the case of a nonresident alien individual, the standard deduction shall be zero.

B. Reason for Change to Withholding Procedures for Nonresident Alien Employees

The income tax withholding tables in Publication 15 (Circular E), Employer's Tax Guide (January 2005 revision), for use with the percentage method of withholding and the wage bracket method of withholding assume that an employee will be entitled to a standard deduction in determining the employee's federal income tax liability. Under the withholding tables, an employer does not withhold any amount of income tax until the employee has received an amount (for example, \$2,650 for an annual payroll period) that will be subject to tax after taking into account the standard deduction and the employee's claimed withholding allowance(s). However, because a nonresident alien individual is not permitted to claim the standard deduction, nonresident alien employees have been given special instructions for completing their withholding exemption certificates in an effort to offset the assumed standard deduction built into the withholding tables. These instructions were intended to prevent underwithholding.

Specifically, Publication 15 (January 2005 revision) directs that when completing

Form W-4, a nonresident alien employee is required to request an additional income tax withholding amount, depending on the payroll period. A chart is provided in Publication 15 setting forth the additional income tax withholding amount that is required to be requested by the nonresident alien employee for each type of payroll period. Nonresident alien students and business apprentices from India are not subject to the requirement to request additional income tax withholding.

The current withholding rules result in overwithholding on wages of nonresident alien employees who have small amounts of remuneration from services within the United States because the additional amount that the nonresident alien employee must request for withholding purposes is withholding liability that will apply from the first dollar of wages. Thus, even if the amount of the nonresident alien employee's total annual wages for services performed in the United States is less than the personal exemption amount, the current withholding rules require income tax to be withheld. A nonresident alien in this situation must file a return and request a refund to get back the amount withheld.

III. WITHHOLDING RULES THAT WILL BE EFFECTIVE FOR WAGES PAID TO NONRESIDENT ALIEN EMPLOYEES ON OR AFTER JANUARY 1, 2006

A. Nonresident Alien Employees Completing Form W-4

When completing Form W-4 to provide information with respect to withholding on wages to be paid on or after January 1, 2006, nonresident alien employees are required to:

- (1) Not claim exemption from withholding;

- (2) Request withholding as if they are single, regardless of the actual marital status;
- (3) Claim only one allowance; and
- (4) Write "Nonresident Alien" or "NRA" above the dotted line on line 6 of Form W-4.

With respect to the third requirement, if the nonresident alien is a resident of Canada, Mexico, or South Korea, he or she may claim more than one allowance.

When completing a Form W-4 that will apply to wages paid on or after January 1, 2006, nonresident alien employees will no longer be required to request an additional withholding amount. However, like all other employees, nonresident aliens may request additional withholding at their option.

B. Employer Calculation of Withholding on Wages of Nonresident Alien Employees

Beginning with wages paid on or after January 1, 2006, employers are required to calculate income tax withholding under section 3402 of the Code on wages of nonresident alien employees (except for students and business apprentices from India) using a new procedure. Under this procedure the employer will add an amount to the wages of the nonresident alien employee solely for purposes of calculating the income tax withholding for each payroll period; the specific amount depends on the payroll period. Employers will determine the income tax to be withheld by applying the tables to the sum of the wages paid for the payroll period plus the additional amount. Adding this amount will offset the assumed standard deduction that is incorporated into the tables without requiring income tax to be withheld from wages that will fall below the personal exemption when annualized. The added amount is not income or wages to the employee, does not affect income, Federal Insurance Contributions Act (FICA) or

Federal Unemployment Tax Act (FUTA) tax liability for the employer or the employee, and is not to be reported as income or wages.

The amounts added under this procedure as set forth in the chart below are added purely for purposes of calculating the amount of the income tax withholding on the wages of the nonresident alien employee. These chart amounts should not be included in any box on the Form W-2, Wage and Tax Statement.

The amount required to be added to the wages of a nonresident alien employee for purposes of calculating income tax withholding is the highest wage amount to which a zero withholding rate applies as shown in the Table for the Percentage Method of Withholding for a single person (including a head of household) for each payroll period. The tables are published periodically in Publication 15.

For 2006, the amount required to be added to the wages of a nonresident alien employee for purposes of calculating income tax withholding, for each length of payroll period is as follows:

<u>Payroll period</u>	<u>Add additional</u>
Weekly	\$ 51
Biweekly	\$ 102
Semimonthly	\$ 110
Monthly	\$ 221
Quarterly	\$ 663
Semiannually	\$ 1,325
Annually	\$ 2,650

Daily or Miscellaneous (each \$ 10.20
day of the payroll period)

Updated tables are published each year in Publication 15. If intra-year changes in the tables are released, they may be in other IRS publications

Thus, in determining the amount of income tax withholding on wages of nonresident alien employees, employers will calculate the amount of wages to be used in applying the applicable income tax withholding tables as follows: Employers will add to gross wages (to be included on Form W-2) the additional amount pursuant to the procedure described above (not included on Form W-2). If the employer uses the percentage method, the employer then should subtract an amount for withholding allowances for the payroll period, and then apply the percentage method withholding tables to the remainder. If the employer uses the wage bracket method, the employer should not subtract an amount for withholding allowance(s), because withholding allowances are reflected in the wage bracket withholding tables. Under the wage bracket method, the employer will apply the wage bracket tables to the sum of the gross wages and the additional amount added pursuant to the chart.

Thus, for example, if a nonresident alien employee is receiving wages on an annual payroll period in 2006, the employer is required to add \$2,650 to the wages to determine the amount of income tax withholding. Then, if the employer is using the percentage method of withholding, the employer would subtract the applicable amount for withholding allowance(s) and apply the applicable percentage method withholding table for an annual payroll period for single employees. The \$2,650 addition would not

be included on Form W-2. The amount to be added to wages for a payroll period in calculating income tax withholding is the same for each payroll period as long as the employee retains the same payroll period.

C. Example Comparing 2005 Withholding Rules with 2006 Withholding Rules

A nonresident alien employee earns \$250 per month for services performed in the United States and has a monthly payroll period. The employee has no other U.S. source income. The employer uses the wage bracket method of withholding.

(1) 2005 Withholding.

As a nonresident alien, the employee is required to complete Form W-4 claiming single status and no more than one withholding allowance. The employee is also required to request on Form W-4 that an additional \$33.10 be withheld from his/her wages for each monthly payroll period. The nonresident alien employee completes Form W-4, claiming single status and one withholding allowance and requesting additional withholding of \$33.10. In calculating the amount of withholding for the employee, the employer applies the wage bracket withholding table applicable for a single employee receiving \$250 of wages for a monthly payroll period and claiming one withholding allowance. The employee has no withholding under the withholding tables. However, because the employee has requested \$33.10 of additional withholding, the employer will withhold \$33.10 each pay period. If the employee's wages are the same for each month in the year, the employer will withhold a total of \$397.20 for the year (\$33.10 times 12). The employee's total gross income from U.S. sources for the

year will be \$3,000. After subtraction of \$3,200 for the personal exemption amount, the employee will have no taxable income and no income tax liability. The employee will have to file an income tax return to claim a refund of the \$397.20 that was withheld.

(2) 2006 Withholding.

As a nonresident alien, the employee is required to complete Form W-4 claiming single status and no more than one withholding allowance, but the employee is not required to request an additional amount of withholding. The employee is required to write "nonresident alien" or "NRA" above the dotted line on line 6 of Form W-4. The nonresident alien employee completes Form W-4, claiming single status, one withholding allowance, and writing "nonresident alien" above the dotted line on line 6 of Form W-4. Because the employee has a monthly payroll period, the employer adds \$221 to the \$250 of wages for the monthly payroll period solely for purposes of calculating the amount of withholding under the applicable table. This \$221 would not be reflected on the Form W-2 of the employee. The employer applies the wage bracket withholding table applicable for a single employee receiving \$471 of wages (the total of \$250 actual wages and \$221 additional amount) for a monthly payroll period and claiming one withholding allowance. Under the applicable table, the employee would have no withholding. If the employee's wages are the same for every month in the year, the employee will have \$3,000 of gross income from U.S. sources. After subtraction of \$3,300 for the personal exemption amount, the

employee will have no taxable income and no income tax liability.

D. What Employers and Employees Should Do to Implement the New Withholding Requirements

Employers hiring new nonresident alien employees who will receive remuneration for services performed in the United States for the first time on or after January 1, 2006 should instruct the new employees to complete Form W-4 in accordance with the instructions provided in this Notice. An employer who already has one or more nonresident alien employees with Forms W-4 on file requesting additional withholding pursuant to the current instructions in Publication 15 should advise such employees to file new Forms W-4 with the employer at an appropriate time such that the new Forms W-4 will be effective for wages paid on or after January 1, 2006. Forms W-4 furnished by employees in place of Forms W-4 in effect with an employer shall take effect at the beginning of the first payroll period (or the first payment of wages made without regard to a payroll period) on or after the 30th day after the day on which such Form W-4 is furnished. The employer may elect to make the replacement Form W-4 effective on or after the day the replacement Form W-4 is furnished by the employee and before the 30th day after the day on which the replacement Form W-4 is furnished.

The new Form W-4 must reflect single status and only the number of withholding allowances the employee is entitled to claim (generally one) with the employer. The nonresident alien employee is not required to request additional withholding on the new Forms W-4. However, depending on the employee's circumstances, the employee may want to request additional withholding. To assist the employer in applying the correct

withholding procedure to the employee's wages, the Form W-4 filed by the nonresident alien employee should also be marked to indicate nonresident alien status by the employee. The nonresident alien employee should write "nonresident alien" or "NRA" above the dotted line after the words "Additional amount, if any, you want withheld from each paycheck" and before the box on line 6 of Form W-4. Employers maintaining electronic Form W-4 systems should make an appropriate modification in their systems that would allow employees to identify themselves as nonresident aliens. Also, employers using permissible substitute forms should make an appropriate modification to their forms.

An employee may submit a new Form W-4 to his employer at any time. The new form automatically supersedes the previous form provided to the employer. However, if a nonresident alien employee submits a new Form W-4 to his employer following the instructions in this Notice and eliminating the request for withholding an additional amount, and the employer is not yet prepared to implement the new procedures for calculating the amount of income tax to be withheld at the time the new Form W-4 goes into effect, the nonresident alien employee may be subject to underwithholding. (See section III of this notice for the length of the employer's transitional relief period.)

E. Students and Business Apprentices from India

The new procedure described in Part III of this notice does not apply if the nonresident alien employee is a student or business apprentice who is or was a resident of the Republic of India immediately before visiting the United States and who is present in the United States principally for the purpose of his or her education or training. This

exception only applies for such period of time as may be reasonable or customarily required to complete the education or training undertaken. See Article 21 of the Tax Convention with the Republic of India (generally effective January 1, 1991).

F. Effect on Supplemental Wage Payments that the Employer is Subjecting to a Flat Rate of Withholding.

This notice has no effect in determining the amount of withholding on supplemental wages if the supplemental wages are subject to mandatory flat rate withholding (currently 35 percent) or the employer is applying an optional flat rate of income tax withholding (currently 25 percent) on such supplemental wages. See section 904(b) of the American Jobs Creation Act of 2004, Pub.L. 108-357, establishing a mandatory flat rate for withholding on supplemental wages (currently 35 percent) to the extent that the employee's total supplemental wages from the employer exceed one million dollars during the calendar year, and section 31.3402(g)-1 of the regulations, providing that employers generally have an option of withholding at a flat rate (currently 25 percent) on supplemental wage payments that are not subject to the mandatory flat rate of withholding.

G. Effect on the Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA)

This notice has no effect in determining FICA and FUTA taxation on remuneration for services performed by nonresident alien employees.

H. Effect on Nonresident Alien Individuals Who Have No Wages subject to Federal Income Tax Withholding under Section 3402

This notice has no effect on nonresident alien individuals who have no wages subject to federal income tax withholding under section 3402. For example, if a nonresident alien employee is eligible for a tax treaty withholding exemption and has a valid Form 8233, Exemption from Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual, in effect with the employer, this notice has no application to remuneration paid by the employer to the employee that is exempt from income tax withholding under the treaty.

III. EFFECTIVE DATE

This notice is effective with respect to wages paid to nonresident alien employees on or after January 1, 2006. However, with respect to wages paid prior to January 1, 2007, the Internal Revenue Service will not assert an employer's liability for underpayments of income tax withholding and related interest and penalties resulting solely from the failure to apply the new withholding procedure in this notice to payments of wages made to nonresident alien employees, provided the employer has made a good faith effort to implement the withholding requirements in this notice as soon as possible. The transitional relief in the previous sentence does not affect the liability of employees for federal income tax.

IV. DRAFTING INFORMATION

The principal author of this notice is Alfred G. Kelley of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities). For further information regarding this notice contact Mr. Kelley at (202) 622-6040 (not a toll-free call).